

## Message Text

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ACTION EUR-12

INFO OCT-01 EA-07 ISO-00 NEA-10 AID-05 CIAE-00 COME-00

EB-07 FRB-03 INR-07 NSAE-00 USIA-06 TRSE-00 XMB-02

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FM AMEMBASSY LONDON

TO SECSTATE WASHDC PRIORITY 8417

INFO AMEMBASSY PARIS

AMEMBASSY BONN

AMEMBASSY TOKYO

AMEMBASSY ROME

AMEMBASSY BERN

USMISSION OECD PARIS

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PASS TREASURY FOR SYVRUD,AND FRB

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SUBJECT: LONDON FOREIGN EXCHANGE MARKET IN THE WAKE  
OF THE ITALIAN MARKET CLOSING

1. CURRENT EXCHANGE MARKET DEVELOPMENTS: IN THE WAKE OF  
THE ITALIAN EXCHANGE MARKET CLOSING, STERLING HAS REMAINED  
RELATIVELY STABLE. UNLIKE THE NERVOUS AND UNCERTAIN CON-  
DITIONS WHICH EXISTED LAST SUMMER, THE DISRUPTION OF NOR-  
MAL MARKET ACTIVITIES DID NOT GENERATE A MAJOR RUN AGAINST  
THE POUND. ON THURSDAY, JANUARY 22, THERE APPEARED TO BE  
AN UPSURGE OF SPECULATIVE PRESSURE AND SIGNS OF MAJOR  
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SWITCHING OUT OF STERLING INTO DOLLARS AS THE RATE WAS

PUSHED TO THE \$2.0152 LEVEL AT MIDDAY. HOWEVER, THIS WAS A FAIRLY SHORT-LIVED ATTACK AND THE RATE RETURNED TO THE \$2.02 LEVEL BY CLOSING. THIS WAS VIEWED BY MOST TRADERS AS A "SPILL-OVER" EFFECT FOLLOWING THE ITALIAN CLOSING AND THE SPECULATIVE PRESSURE AGAINST THE FRENCH FRANC. TRADERS REPORT THAT AT ONE POINT LAST WEEK, THE BANK OF ENGLAND APPEARED TO BE SUPPORTING THE DOLLAR RATE AT \$2.0255 ALTHOUGH THERE ARE CONTINUING REPORTS THAT THE BANK OF ENGLAND IS ACTIVE ON BOTH SIDES OF THE MARKET. TRADERS IN MAJOR CLEARING BANKS REPORT A BELIEF THAT THERE HAS BEEN INCREASED CENTRAL BANK INTERVENTION IN RECENT WEEKS. NONETHELESS, BASED ON QUALITATIVE JUDGMENTS THE VOLUME OF FUNDS MOVING THROUGH LONDON APPEAR TO REMAIN FAIRLY LOW.

2. EVENTS DURING THE PAST SEVEN TO TEN DAYS (OTHER THAN THE ITALIAN MARKET CLOSING) THAT REPORTEDLY MOVED THE STERLING/DOLLAR RATE INCLUDED REPORTS THAT SMALLER OPEC MONETARY AUTHORITIES WERE SHIFTING FUNDS OUT OF STERLING INTO DOLLARS AND THAT STERLING PAYMENTS FOR OIL WERE BEING TRANSFERRED INTO DOLLARS. PUBLICATION OF THE CHANCELLOR'S LETTER TO THE IMF OUTLINING THE PROSPECTIVE SIZE OF THE GOVERNMENT'S DEFICIT THIS FISCAL YEAR -- UP TO 12 BILLION POUNDS RATHER THAN THE 9 BILLION POUND FIGURE FORECAST WHEN THE BUDGET WAS ANNOUNCED -- ALSO HAD A NEGATIVE EFFECT. THIS WAS OFFSET IN PART BY THE REALIZATION THAT UP TO 2 BILLION DOLLARS WOULD BE AVAILABLE FROM THE IMF. (WE UNDERSTAND THAT THE FUNDS FROM THE IMF OIL FACILITY WERE DRAWN ON FRIDAY, JANUARY 23, AND WILL BE REFLECTED IN THE JANUARY RESERVE FIGURES.) BETTER THAN EXPECTED CURRENT ACCOUNT FIGURES, WHICH WERE RELEASED ON FRIDAY, JANUARY 16, LED TO SOME STRENGTHENING EARLY IN THE WEEK OF JANUARY 19, BUT THE ANNOUNCEMENT OF UNEXPECTED AND RATHER SIZEABLE INCREASES IN THE UNEMPLOYMENT RATE REGENERATED AN AIR OF UNCERTAINTY ABOUT THE DOMESTIC ECONOMIC OUTLOOK. THE CONTINUING DECLINE IN U.S. INTEREST RATES HAS HAD POSITIVE EFFECTS ON THE DEMAND FOR STERLING. HOWEVER, THE BANK OF ENGLAND'S MINIMUM LENDING RATE WAS CUT BY 1/4 PERCENT ON FRIDAY, JANUARY 23, TO 10-1/2 PERCENT. IF U.S. RATES TEND TO FIRM, THIS WILL

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PUT STRAIN ON THE CONTINUATION OF AN INFLOW OF SHORT-TERM STERLING FUNDS.

3. LOOKING AHEAD, DEVELOPMENTS CONCERNING THE FORMULATION OF THE SECOND STAGE OF THE GOVERNMENT'S INCOMES POLICY WILL BE CLOSELY WATCHED. UNFAVORABLE UNION REACTION WILL HAVE A DEPRESSANT EFFECT ON THE MARKET. A PRE-MATURE REFLATION ATTEMPTING TO ALLEVIATE UNEMPLOYMENT

WOULD PROBABLY PUT SOME STRAIN ON THE RATE. IN THE VERY SHORT TERM, THE ABILITY OF THE FRENCH GOVERNMENT TO MAINTAIN THE RELATIVE POSITION OF THE FRANC WILL BE A KEY FACTOR ACCORDING TO TRADERS AND CENTRAL BANK OFFICIALS. THERE WERE RUMORS IN THE MARKET LAST FRIDAY OF POSSIBILITY OF A WEEKEND FRANC DEVALUATION, WHICH ADDED UNCERTAINTY. SOME MARKET SOURCES CONSIDER THAT IF A MAJOR DEVALUATION OF THE FRENCH FRANC SHOULD OCCUR, THEN A SPECULATIVE ATTACK ON STERLING WOULD FOLLOW.

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